No. 21,185

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JOAN E. HELLER TRUST, et al.,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 89-106),[1/] are not officially reported. The supplemental memorandum findings of fact and opinion (I-R. 112-115) are not officially reported.

JURISDICTION

This petition for review (I-R. 116-119) involves deficiencies in federal income tax for the taxable years 1955, 1956 and 1957 in the approximate amount of $82,600. On March 25, 1960, the Commissioner

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1/ "I-R." references are to Volume I of the record on appeal.

of Internal Revenue mailed to the taxpayers notices of deficiency asserting deficiencies in tax for the years 1955, 1956 and 1957 totaling $163,320.10. (I-R. 7-11, 22-29, 40-47, 58-65, 76-84.) Within ninety days thereafter, on June 14, 1960, the taxpayers filed petitions with the Tax Court for a redetermination of these deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-12, 16-30, 34-48, 52-66, 70-85.) The decisions of the Tax Court were entered March 18 1966. (I-R. 107-111.) The case is brought to this Court by a petition for review filed June 13, 1966 (I-R. 116-119), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTIONS PRESENTED

1. Whether the Tax Court was correct in deciding that the gains on the sales and exchange of duplex houses were taxable as ordinary income rather than capital gain because taxpayer [2] held these properties primarily for sale to customers in the ordinary course of his trade or business.

2. Whether the Tax Court was correct in deciding that the deferred payment contracts executed by purchasers of the duplexes had a fair market value of 50 percent of face value and, to that extent, were includable in taxpayers' income in the year of sale.

2/ The Tax Court noted (I-R. 99, fn. 2) that it was only necessary to focus upon the activities of Smotkin since it was clear from the record that he was the dominant figure in the real estate ventures and any finding as to him was equally applicable to the other taxpayers. For the sake of convenience all references will be to Edward E. Smotkin as taxpayer.

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) General Rule.--The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

*   *   *

(26 U.S.C. 1964 ed., Sec. 451.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.--The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized--

*   *   *

(26 U.S.C. 1964 ed., Sec. 1001.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

*   *   *

(26 U.S.C. 1964 ed., Sec. 1221.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

* * *

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

(26 U.S.C. 1964 ed., Sec. 1222.)

STATEMENT

The facts relevant to this appeal, as found by the Tax Court (I-R. 90-98), some of which were stipulated, are substantially as follows:

Edward S. Smotkin and Betty J. Smotkin, husband and wife, are residents of Tuscon, Arizona. They filed their joint Federal income tax returns for the years in issue with the District Director of Internal Revenue, Phoenix, Arizona. The Joan E. Heller Trust (formerly Joan E. Smotkin Trust), the Carole D. Smotkin Trust and the Harold J. Smotkin Trust are trusts created under the laws of the State of Arizona. The trustee of all the trusts is the Arizona Trust Company, and its principal place of business is Tuscon, Arizona. The income tax returns for each of the trusts for the years here involved were filed with the District Director of Internal Revenue, Phoenix, Arizona. Robert M. Heller and Joan E. Heller, husband and wife, have a mailing address of 55 Camino Espanol, Tuscon, Arizona. Their joint federal income tax return for 1957 was filed with the District Director of Internal Revenue, Phoenix, Arizona. (I-R. 90-91.)

Beginning in 1938, taxpayer entered into a partnership agreement with George Bromley and from 1938 to 1941 the partnership was in the house siding business in Detroit, Michigan, and Columbus, Ohio. In 1941 the partnership, known as American Homes Association, terminated its house siding business and engaged in the business of developing, building and selling real estate in the area of Columbus, Ohio. In the latter part of 1941 Bromley left the partnership and, thereafter, taxpayer operated the same business as an individual under the name American Homes Association until the business was terminated in 1944. (I-R. 91.)

In 1944, for reasons of his wife's health, taxpayer retired and moved to Beverly Hills, California. Thereafter he entered the photo-finishing business, which business was terminated in 1948, when he moved to Tucson, Arizona. In 1948 taxpayer formed a partnership with Bromley and with Jay Smotkin (taxpayer's brother) under the name of American Homes Association, hereinafter called the partnership. After Jay was bought out in 1949, taxpayer had a two-thirds interest and Bromley a one-third interest in the capital, profits and losses of the partnership. (I-R. 91.)

In February 1948 the partnership purchased an 80-acre tract of land near Tucson, Arizona, and by the latter part of 1949 or early 1950 the partnership had purchased two adjacent 80-acre tracts of land. During the period from 1948 to June 30, 1951, the partnership built and sold approximately 500 dwelling houses on two of the 80-acre tracts. (I-R. 92.)

During the period from July to November 1951, taxpayer and Bromley incorporated American Homes Association, American Building Company and six rental corporations (American Rentals, National Rentals, Federal Rentals, Joan Rentals, Harold Rentals and Carole Rentals). Taxpayer held a two-thirds interest and Bromley a one-third interest in both American Homes Association, hereinafter called American Homes, and American Building Company. In the last half of 1951 the National Realty Company, which held legal title to the third 80-acre tract for the benefit of taxpayer and Bromley, conveyed such legal title to the six rental corporations, whose stock was issued one-third to taxpayer, one-third to Bromley, and one-third to Bromley as trustee for taxpayer's children. In April 1952 the Arizona Trust Company became successor trustee in the trust created by taxpayer and wife for their children. (I-R. 92.)

During the years 1951 and 1952, 194 duplexes (388 dwelling units) were built on the third 80-acre tract by American Building Company for the six rental corporations. American Building Company was liquidated in January 1953. Prior to completion of the duplexes in July 1952, the six rental corporations applied for mortgage insurance from the Federal Housing Administration. In response to the question on the application form "Do you intend to occupy, rent, or sell this property?" the applicar answered "Rent", and in response to the second part of the same question, which asked for the "[p]roposed sale price (if for sale)", the applicants gave such sale price as $15,750 for each duplex. (I-R. 92-93.)

Construction financing for the 194 duplexes was obtained through banks and private individuals, and the loans were secured by the duplex lots, by othe real estate owned by taxpayer and Bromley and by the personal guarantees of taxpayer and Bromley. Permanent financing was obtained from bank and trust companies, an insurance company and a savings and loan association, and on some of these loans the personal guarantees of taxpayer and Bromley were required. (I-R. 93.)

The construction price charged by American Building Company to the rental corporations was $12,600 per duplex, which included coolers, venetian blinds, stoves and refrigerators. The $12,600 figure was also the sum of the permanent financing on each duplex. The land was reflected on the books of the rental corporations at $200 per duplex lot, making a total cost figure of $12,800 for each duplex. (I-R. 93.)

On January 2, 1952 a management agreement was executed by American Homes and the six rental corporations under which American Homes agreed to manage the 194 duplexes owned by the rental companies, to act as rental and operating agent and collect rentals, to advertise the properties for rental, and to maintain and repair the properties. It was agreed that American Homes would receive a commission of 10 percent of gross rentals during 1952 and 20 percent of gross rentals after January 1, 1953, and would pay all expenses in connection with the advertising, leasing, maintenance and repair of the properties. (I-R. 93.)

During 1953 the occupancy rate of the duplexes was about 65 percent, while during the years 1954 and 1955 the occupancy rate was about 72 percent. The financial statements of the rental corporations during the

period 1953 through 1955 show consistent losses. During the first three and one-half months the duplexes were rented, they were rented by written lease agreements. Thereafter, they were rented on an oral, month-to-month basis. (I-R. 94.)

In order to increase the tenant occupancy of the duplexes, taxpayer proposed early in 1954 that a swimming pool be constructed and that 120 of the units be furnished. Bromley was unwilling to make these changes, which would cost approximately $120,000, and on February 24, 1954 taxpayer and Bromley agreed to a division and distribution of their various property interests. Subsequently, the ownership in the six rental corporations and in American Homes was as follows: taxpayer, one-third; taxpayer's wife, one-third; and the Arizona Trust Company as trustee for taxpayer's three children, one-third. In 1954 American Homes constructed the swimming pool and purchased furniture for some of the rental units. (I-R. 94.)

During 1955 taxpayer obtained medical care and advice on numerous occasions for various ailments, including paroxysmal auricular tachycardia and a peptic ulcer of the duodenal. Taxpayer also suffered from general tension. Early in 1955 taxpayer was also treated by a cardiovascular specialist in San Francisco, California. Taxpayer was hospitalized in Tucson in the fall of 1955 for treatment of his peptic ulcer. Taxpayer had previously been treated by the cardiovascular specialist in San Francisco in 1952 and 1953. (I-R. 94-95.)

On September 1, 1955, the six rental corporations were liquidated and 186 duplexes were distributed to the stockholders in liquidation. The remaining eight duplexes had been sold between June 1 and August 31, 1955. American Homes served as selling agent for the stockholders and

proceeded as rapidly as possible to sell the duplexes. Taxpayer was president of American Homes during the years here in issue. Commencing on or about November 1, 1955, the duplexes were advertised for sale. Prior to that the duplexes were advertised only for rent. American Homes employed extensive newspaper and radio advertising as part of its selling efforts. About September 1955 American Homes moved its office to one of the duplexes, opened a model duplex for display, employed a staff of salesmen to handle the sales, and prepared and distributed sales brochures to customers. At the time of the sale of each duplex it was completely reconditioned and redecorated inside and out by American Homes. In addition, American Homes paid for the closing costs incurred in selling the duplexes. (I-R. 95.)

American Homes also offered the free use of the pool for a temporary period to a purchaser of a duplex and his tenant. The books and records of American Homes show that owners and tenants of the duplexes were not charged for pool service until May 1, 1958. A typical pool agreement stated that after a cut-off date the pool privilege would be optional to the owner and his tenants at a specified annual price. After the sale of duplexes and during the years in issue, American Homes acted as rental agent for some of the new owners. There was no charge for the rental service, but if American Homes collected the rents for the owners and disbursed the rents, a charge of $5 per month was made. The free rental service was to be provided for a five-year period. In addition, American Homes provided free garbage collection service for a limited period of time to owners of duplexes and their tenants. (I-R. 95-96.)

During the period 1955 to 1958, 169 duplexes were sold. The remaining 17 duplexes were exchanged in 1956 for a cattle ranch. Approximately 55 of the duplexes were sold furnished. Most of the duplexes were sold at prices ranging from about $15,000 to about $16,200. (I-R. 96.) A typical sale would be handled in the following manner (I-R. 96):

FHA mortgage assumed by purchaser	$11,419.98
Cash down payment	1,100.00
Contract	2,710.02
Total sales price	$15,230.00

The contract ($2,710.02 in the above example) executed by the purchaser provided for interest of 6 percent per annum and required payments of principal and interest totaling $25 per months, with the entire contract sum due in five years. If the sale involved a furnished duplex, then the contract would require a payment of principal and interest totaling $45 per month. (I-R. 96.)

Taxpayer generally paid American Homes $1,500 for each duplex sold through the period up to November 1956, and he paid $2,000 each for most of the duplexes sold after that date. (I-R. 96.)

During the years 1956 through 1962 the taxpayers also reported on their returns (I-R. 96) the following sales (I-R. 97):

Year	Asset Sold	Date Acquired	Gross Sales Price	Gain
1956	Land	1946 and 1951	$75,000.00	$67,967.19
1957	Land	Not shown	71,000.00	62,745.00
1958	Land	1948 and 1951	10,000.00	8,422.65
	Land	1955	4,021.42	2,258.58
	Land		8,571.43	4,898.34
1959	1/3 interest in ranch	1956 (acquired in exchange for duplexes)	58,942.58	35,263.60
	Land	Not shown	10,000.00	8,790.00
1960	Ranch	1956 (acquired in exchange for duplexes)	9,000.00	5,293.50
1961	Land	1959	28,000.00	25,691.14
1962	Car wash & land	1961	74,900.00	21,663.09
	Land & Bldg.	1956	44,008.94	40,957.27

In 1956 taxpayer obtained a real estate broker's license as a designated broker for American Homes. Such license has been renewed annually to the present time. Taxpayer is a member of the National Board of Realtors and the Tucson Real Estate Board. (I-R. 97.)

The taxpayers retained portions of each of three 80-acre tracts for commercial development. Subsequent to the sale of the duplexes, the commercial property was developed, with American Homes acting as contractor in building stores. The name of American Homes has now been changed to Greater Broadway Development Company. Taxpayer has recently been active in seeking a rezoning of certain land in the Tucson area to permit high rise structures. (I-R. 97.)

Taxpayers, on their respective federal income tax returns for the years here involved, reported the gains realized from the sale of the duplexes during that period as long-term capital gains. In addition, taxpayers (as cash basis taxpayers) considered the contracts received by them from the purchasers of the duplexes as having no ascertainable

fair market value and, accordingly, reported the payments on the contracts as income only in the year in which the payments exceeded their adjusted basis. (I-R. 98.)

The Tax Court found (I-R. 102) that the duplexes were being held primarily for sale to customers in the ordinary course of taxpayer's real estate business and that the gains realized during the taxable years were taxable as ordinary income.

The Tax Court also found (I-R. 104) that the contracts had a fair market value when received equal to 50 percent of their face value and were includable in taxpayers' taxable income at the fair market value in the year of sale.[3/]

SUMMARY OF ARGUMENT

Taxpayer maintains that 186 duplexes which he sold or exchanged had been held for investment purposes. If true, then the profits would be entitled to be treated as long-term capital gains. If not, then the profits would be taxed as ordinary income.

Taxpayer contends that the duplexes had been acquired for rental purposes and had in fact been rented for three years prior to sale. However, the record supports an inference that even when the duplexes were originally acquired, taxpayer's primary purpose was sale. More important is that the original purpose, although important, is not controlling. Rather, it is the purpose for which taxpayer is holding the property during the taxable year which controls, and here there is no question that these duplexes were being held solely for sale.

3/ Another issue before the Tax Court was whether the Commissioner was correct in disallowing all amounts paid by taxpayers as selling commissions to American Homes in excess of 5 percent. (I-R. 97-98.) The Tax Court held (I-R. 106) that the total amounts paid by taxpayers

Taxpayer further urges that these properties were not sold in the course of his business because he was in the rental, not sales, business. Also, he submits that the sales merely constituted the liquidation of an investment. The flaw in such reasoning is that if a taxpayer's activities are similar to those usually engaged in selling realty, then he will be considered to have entered the real estate business. This is true whether or not taxpayer was in the real estate business before and it is immaterial what motivated him to enter the business, i.e., profit or liquidation. The record shows that taxpayer actively engaged in sales activity, employing radio, television, and newspaper advertising; had a model duplex on the premises, obtained a broker's license; and also gave brochures to customers. Thus it is quite apparent that during the taxable years, taxpayer was engaged in the business of selling realty.

The second issue deals with whether or not taxpayers received income in the years of sale. Taxpayers when selling the duplexes obtained from a purchaser a contract wherein the purchaser agreed to pay a specified sum at specified times. The Commissioner determined that these contracts had a fair market value of 50 percent of face value and that income, to that extent, was includable in taxpayers' income tax returns in the year of sale. Taxpayers, maintaining that these contracts had no fair market value, reported the proceeds from these contracts in the years payment were received. The Tax Court correctly--in our view--found that the contracts had a fair market value of 50 percent of face value.

Taxpayers urge that because they received no negotiable instruments with the contracts, the contracts had no fair market value. This is because without possession of a negotiable instrument, they had nothing

which was the equivalent of cash. Although the Tax Court--on whose decisions taxpayers rely--did at one time require that there be a negotiable instrument accompanying a contract before it would find a fair market value, that court has specifically rejected that view now. Therefore it is possible that a contract, standing alone, can have a fair market value. As for the obligations which taxpayers allege were attached to these contracts, thereby making them unmarketable, the record shows that these obligations were those of a corporation and not those of the taxpayers and, therefore, the obligations were in no way connected to the notes.

Both issues being ones of fact, they should be reversed only if clearly erroneous. Insofar as there is ample evidence to support both findings, they should be affirmed.

ARGUMENT

I

THE TAX COURT CORRECTLY HELD THAT DUPLEX HOUSES SOLD AND EXCHANGED BY TAXPAYER WERE NOT CAPITAL ASSETS BECAUSE THEY HAD BEEN HELD BY TAXPAYER PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF HIS TRADE OR BUSINESS

This is another in the long line of cases dealing with the question whether taxpayer held property for investment purposes or whether he held it primarily for sale to customers in the ordinary course of his trade or business. In the proceedings below, the Commissioner contended that taxpayer held 186 duplexes for sale to customers in the ordinary course of business, thereby not qualifying as capital assets (Section 1221(1) of the Internal Revenue Code of 1954,[4/] supra), which

4/ All references to sections are to the 1954 Code, unless otherwise

means that any gain realized on a sale or exchange would be subjected to tax as ordinary income. Taxpayer contended that the duplexes had been held for investment, thereby qualifying as capital assets, and, accordingly, that any gain on a sale or exchange would be entitled to preferential treatment where, as here, the property had been held in excess of six months. Section 1222(3), supra. The Tax Court, with all the evidence before it, concluded (I-R. 102) that taxpayer had held these duplexes primarily for sale to customers as part of his trade or business. This being a question of fact, the narrow issue on appeal is whether this finding was "clearly erroneous." Rollingwood Corp. v. Commissioner, 190 F. 2d 263, 265 (C.A. 9th); Richards v. Commissioner, 81 F. 2d 369, 370 (C.A. 9th); Yara Engineering Corp. v. Commissioner, 344 F. 2d 113 (C.A. 3d); Broughton v. Commissioner, 333 F. 2d 492 (C.A. 6th); Coffey v. United States, 333 F. 2d 945 (C.A. 10th); Tidwell v. Commissioner, 298 F. 2d 864 (C.A. 4th). If not, then, in accordance with the usual standards of review, it is entitled to finality. Commissioner v. Duberstein, 363 U.S. 278.

Despite all the litigation in this area, the facts remains that there "is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business and each case must, in the last analysis, rest upon its own facts." Mauldin v. Commissioner, 195 F. 2d 714, 716 (C.A. 10th). However, as a means of distinguishing between the dealer and the investor, the courts have developed certain guidelines, no one of which is determinative of the

issue. Frankenstein v. Commissioner, 272 F. 2d 135 (C.A. 7th), certiorari denied, 362 U.S. 918. As listed in Gault v. Commissioner, 332 F. 2d 94, 96 (C.A. 2d), these factors include:

(1) The frequency, number and continuity of the sales; (2) subdivision, platting, and other improvements or developments tending to make the property more marketable; (3) the extent to which the taxpayer engaged in sales activity; (4) the length of time the property has been held; (5) the substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income; (6) the nature of the taxpayer's business; (7) the taxpayer's purpose in acquiring and holding the property; (8) the extent of sales promotional activity, such as advertising; and (9) the listing of property for sale directly or through brokers. 5/

We submit that the Tax Court considered these factors, and its finding and decision are correct.

Taxpayer's major contention (Br. 15-18) is that up to the time the properties were sold, his primary purpose was rental and not sale. While the original purpose is a matter of appropriate consideration by the Tax Court, it is not controlling. Rollingwood Corp. v. Commissioner, 190 F. 2d 263, 266 (C.A. 9th); Goldberg v. Commissioner, 223 F. 2d 709, 712 (C.A. 5th); Home Co. v. Commissioner, 212 F. 2d 637 (C.A. 10th);

5/ Cases wherein some or all of the above guidelines were utilized include: Palos Verdes Corp. v. United States, 201 F. 2d 256 (C.A. 9th); Tidwell v. Commissioner, supra; Patrick v. Commissioner, 275 F. 2d 437 (C.A. 7th); Gudgel v. Commissioner, 273 F. 2d 206 (C.A. 7th); Frankenstein v. Commissioner, supra; Mauldin v. Commissioner, supra; Goldberg v. Commissioner, 223 F. 2d 709 (C.A. 5th).

Friend v. Commissioner, 198 F. 2d 825, 288 (C.A. 10th); Dunlap v. Oldham Lumber Co., 178 F. 2d 781, 784 (C.A. 5th).[6/] If the original purpose were controlling, the statute would read "property purchased for sale" rather than "property held * * * for sale." Richards v. Commissioner, 81 F. 2d 369, 372-373 (C.A. 9th). Thus the courts have concluded that the ultimate question for decision, in determining whether property at the time of sale is held for investment or primarily for sale to customers, is the purpose for which taxpayer was holding the property at the time of the sale. Rollingwood Corp. v. Commissioner, supra; Galena Oaks Corp. v. Scofield, 218 F. 2d 217, 218 (C.A. 5th); Friend v. Commissioner, supra, p. 288; Mauldin v. Commissioner, 195 F. 2d 714, 717 (C.A. 10th); Harrah v. Commissioner, 30 T.C. 1236, 1241. However, because the original purpose should be considered and because taxpayer places great emphasis upon it, we shall discuss it; and we submit that there is sufficient evidence to support the Tax Court's finding (I-R. 100) that from the very beginning, taxpayer's primary purpose was sale.

To begin with, there is a complete absence of prior conduct by taxpayer indicating that he held property for rental or investment purposes. To the contrary, the record shows that taxpayer had been active in building, developing and selling real estate since about 1941 (in Columbus, Ohio) and later in 1948 in Tucson, Arizona. (I-R. 99.)

6/ Taxpayer cites (Br. 20) some cases for the proposition that the purpose at time of sale does not govern. These cases held that the trier of fact should not look solely to the intention at the time of sale but should also consider for what purposes taxpayer was holding the property prior to sale. In the case at bar, the Tax Court did consider taxpayer's intention from the time he acquired the land until

Indeed, the land on which the duplexes were built was one of three adjacent 80-acre tracts, all of which were acquired at approximately the same time. (I-R. 92.) On two of these tracts, taxpayer constructed and sold 500 dwelling units. (I-R. 92.) This occurred just prior to the construction of the duplexes. (I-R. 99.) While not conclusive, these facts do show that taxpayer was primarily engaged in building and selling homes and it was quite permissible to consider this aspect of taxpayer's activities.

Taxpayer submits (Br. 16-17) that while he may have built and sold homes previously, he had given up this activity and when he built the duplexes--they were built solely for rental purposes. Of course, a declared expression of intention is not binding upon either the Commission or the courts. Noble v. Commissioner, 368 F. 2d 439, 443 (C.A. 9th). Moreover, there is evidence indicating that renting was not taxpayer's sol intention when he built the duplexes.

Prior to the completion of the duplexes, the six rental corporations applied for mortgage insurance from the Federal Housing Administration (FHA). (I-R. 92.) On the application form, there was a question consisti of two parts (Ex. 56DDD, Question 6):

> Do you intend to occupy, rent or sell this property?
> Proposed sale price (if for sale).

To the first part, taxpayer responded "Rent." The second part was of relevance only to those who had expressed an intent to sell. Nonetheless, taxpayer put down a sales price of $15,750. As the Tax Court noted (I-R. 99-100) this "* * * figure coincides remarkably with the price range of duplexes when they were actually sold." True, such evidence, standing

(Br. 18) that he did not originally intend a sale of these units.

Furthermore, the fact that the houses were rented on oral leases on a month-to-month basis supports the inference which might well be taken that taxpayer wished to keep the duplexes easily available from the very beginning.

Finally, taxpayer's purported reasons for switching from rental to sale are not borne out by the evidence. Thus he claims (Br. 17) that ill health and the deterioration of the rental market in 1955 forced him to sell. Yet his ill health, as the Tax Court noted (I-R. 100), had existed as early as 1952 and 1953, and there is nothing in the record to indicate that his health was any worse in 1955 than in 1952. In fact, taxpayer's health could not have been of such a nature to force him to sell for he not only supervised the repairing of the duplexes (II-R. 50)[7] but he has continued as an executive of American Homes since the sale of the duplexes (I-R. 101). In short, taxpayer's health could not have caused any change in his plans, and the inference remains that in 1955 he was simply implementing his primary purpose--sale of the duplexes.

Nor can much weight be given to taxpayer's claim that the lack of a rental market in 1955 caused him to sell. As the Tax Court pointed out (I-R. 100), taxpayer's own testimony was that the rental market had collapsed by the middle of 1952. If so, then losses could have and should have been anticipated. Yet, within one year of completion of the duplexes, taxpayer had consulted with an appraiser as to what price could be obtained

7/ "II-R." references are to Volume II of the record on appeal, which contains the transcript of proceedings in the Tax Court.

if some of the duplexes were sold. (II-R. 68-71, Ex. XXX.) If the rental market was depressed in 1952 and therefore losses could have been anticipated, taxpayer's willingness to consider sale so quickly again indicates that he was not primarily holding the units for rent.

Moreover, taxpayer claimed that due to factories closing, there was a poor employment picture, which meant there was little demand for rental units for workers. While this may have been true in 1952, it was not the situation in 1955. (I-R. 100.) In fact, after 1952, the general employmen situation was on the upswing in the Tucson area. (II-R. 73, 74; Ex. 80-ZZZ Thus it is apparent that neither health nor economic conditions in 1955 could have been the reason for taxpayer to give up his purported primary purpose.[8/]

As we noted previously, taxpayer's purpose in acquiring the property, or even his purpose in holding the property prior to sale, is not controlli Rather, it is his purpose at the time of sale, i.e., his purpose in holding the property during the taxable years. Here, of course, there is no questi that from late 1955 to 1958, taxpayer's chief--indeed, sole--purpose was sale of the duplexes. Thus the only question remaining is whether these properties were sold in the ordinary course of taxpayer's trade or business.

8/ Taxpayer claims (Br. 15) that the Tax Court misinterpreted and misapplied the Supreme Court's directive as set forth in Malat v. Riddell, 383 U.S. 569. In that case, taxpayer had a "dual purpose" in acquiring the property, i.e., to develop it for rental purposes or to sell it. The Supreme Court, resolving a conflict in the appellate courts as to whether a "primary" purpose meant "substantial" or "first in order of importance," decided upon the latter. It then remanded the case to the District Court in order that taxpayer's primary purpose might be ascertained. Here, of course, the Tax Court noted (I-R. 101) taxpayer did have a rental purpose in mind when acquiring the property, but that the purpose of first importance was sale. As our brief shows, there is sufficient evidence to support this finding.

In other words, was taxpayer engaged in the business of selling dwelling units during the taxable years?

Although taxpayer refers to the sale of the duplexes as a liquidation (Br. 16, 17), it is well established that the fact that property is sold for purposes of liquidation does not foreclose the determination that a trade or business is being conducted by the seller. Ehrman v. Commissioner, 120 F. 2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668; Commissioner v. Boeing, 106 F. 2d 305, 309 (C.A. 9th), certiorari denied, 308 U.S. 619; Richards v. Commissioner, supra; Home Co. v. Commissioner, supra; White v. Commissioner, 172 F. 2d 629, 630-631 (C.A. 5th). As stated by this Court in Ehrman v. Commissioner, supra (p. 610)--

> We fail to see that the reasons behind a person's entering into a business--whether it is to make money or whether it is to liquidate--should be determinative of the question of whether or not the gains resulting from sales are ordinary gains or capital gains. The sole question is--were the taxpayers in the business of subdividing real estate?

Or, as said in Home Co. v. Commissioner, supra (p. 641)--

> One may, of course, liquidate a capital asset. To do so it is necessary to sell. The sale may be conducted in the most advantageous manner to the seller and he will not lose the benefits of the capital gain provision of the statute, unless he enters the real estate business and carries on the sale in the manner in which such a business is ordinarily conducted. In that event, the liquidation constitutes a business and a sale in the ordinary course of such a business and the preferred tax status is lost.

What, then, do the courts look to in order to determine whether a taxpayer's activities were such as to constitute the carrying on of a real estate business?

Essentially the courts look to the general "busyness" of the taxpayer, and this is measured by the frequency and continuity of sales, the extent of advertising, whether real estate agents were employed, and whether purchasers were actively solicited. Commissioner v. Boeing, supra, p. 309; Goldberg v. Commissioner, supra, p. 712; Home Co. v. Commissioner, supra, p. 641. Where these are minimal, then taxpayer's activities are not such as to amount to the everyday operation of a business. But in the case at bar, it is clear that taxpayer's activities clearly constituted the operatio of a business.

Taxpayer began selling the duplexes in November 1955. (Ex. 60-HHH(1).) Approximately two months later (January 1956), he applied for and obtained a real estate broker's license as a designated broker for American Homes. (Ex. 63-KKK.) The advertising was extensive, employing newspaper, televisio and radio. (Ex. 60-HHH(1) & (2); Ex. 61-III.) Sales brochures were distributed to customers. (I-R. 100; Ex. WWW.) A model duplex was opened for display purposes and all the units were reconditioned and redecorated, inside and out. (I-R. 100.) A total of 169 duplexes were sold from 1955 to 1958, with most of the prices raning from $15,000 to $16,200. (I-R. 101.) Nor did these sales mark the end of taxpayer's real estate activities, for, as the Tax Court noted (I-R. 101), taxpayer continued in the real estate business in subsequent years.

The above facts amply demonstrate that no matter what business taxpayer was in before or after the taxable years, he was clearly in the business of selling realty from 1955 to 1958. To contend otherwise, as does taxpayer (Br. 17-18), is a contention completely without merit.

Finally, there is no dispute here on the proposition that a taxpayer engaged in some phase of the real estate business may take advantage of real estate investment opportunities and receive preferential long-term capital gain treatment on profit from their subsequent sale. It is a question of fact in each case as to whether a taxpayer's "investment" activities are so different from those of a taxpayer who sells realty so as to require that the two be treated differently. The taxpayer seeking the preferential treatment has the burden of establishing the line of demarcation in order to prevail. As the record clearly demonstrates, this taxpayer did not carry that burden.

II

THE TAX COURT WAS CLEARLY CORRECT IN HOLDING THAT THE DEFERRED PAYMENT CONTRACTS EXECUTED BY PURCHASERS OF DUPLEXES HAD A FAIR MARKET VALUE OF 50 PERCENT OF FACE VALUE AND TO THAT EXTENT, WERE INCLUDABLE IN TAXPAYERS' INCOME IN THE YEAR OF SALE

Section 1001(a), *supra*, provides that "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * *." Section 1001(b), *supra*, defines "amount realized" as being "the sum of any money received plus the fair market value of the property (other than money) received." A cash basis taxpayer, such as those here, would include his gain in the year received. Section 451, *supra*. In the instant case, when taxpayers sold a duplex they generally received from the buyer: (1) cash down payment and (2) a deferred payment contract providing for monthly payments with the entire contract sum due in five years. (I-R. 96.) It is taxpayers' contention here (Br. 23-25), as it was below, that these contracts had no ascertainable

fair market value and thus were income only in the year payments were actually received. On the other hand, the Commissioner determined that the contracts had a fair market value of 50 percent of their face value and, therefore, were includable (to that extent) in taxpayers' income in the year of sale. On the bais of the entire record, the Tax Court found (I-R. 104) they had "a fair market value when received equal to 50 percent of their face value and that they are includable in petitioners' taxable income at that fair market value in the year of sale." Fair market value is a question of fact. In re Williams' Estate, 256 F. 2d 217, 220 (C.A. 9th); Penn v. Commissioner, 219 F. 2d 18, 20 (C.A. 9th); Marsack's Estate v. Commissioner, 288 F. 2d 533, 535 (C.A. 7th) Therefore, unless clearly erroneous, this finding may not be reversed on appeal. Commissioner v. Duberstein, supra.

The major thrust of taxpayers' contention (Br. 24-25) is that these contracts could not have had an ascertainable fair market value because they, taxpayers, received no negotiable instruments, i.e., nothing that could be considered the equivalent of cash. While it is true that some courts have made a distinction between taxpayers who received negotiable instruments (note or mortgage) and those who did not and, in turn, concluded that the former had an amount realized, while the latter did not have an amount realized, this Court in Phillips v. Frank, 295 F. 2d 629, 633, termed the distinction "illusory." Equally true is that the Tax Court, upon whose cases taxpayers rely, has renounced its former reliance upon such a distinction. Estate of Ennis v. Commissioner, 23 T.C. 799, non-acquiescence, 1956-2 Cum. Bull. 10. See especially

Perelman v. Commissioner, 41 T.C. 234, 242, fn. 11, acquiescence, 1956-2 Cum. Bull. 6. See also Darby Investment Corp. v. Commissioner, 315 F. 2d 551 (C.A. 6th). In short, a contract may have a fair market value even if it is not a negotiable instrument. Cowden v. Commissioner, 289 F. 2d 20, 24 (C.A. 5th). Therefore, the question is not whether these contracts were negotiable, but whether they had a fair market value when received. The Tax Court concluded that they did have a value and, we submit, there is evidence to support such conclusion.

It is true, as taxpayers note (Br. 25-26), that Klafter did testify that these contracts had no market value, but this was only after he had concluded that the contracts were not negotiable (II-R. 59). Of course, the negotiability of the contracts has little bearing on the question, as we have already discussed. Later, Klafter testified that there would have been no market for these contracts because he assumed that certain conditions were attached to them. (II-R. 65.) But when asked whether without these purported conditions the contracts would be marketable, that is, would an expert such as he buy them, Klafter stated that he would. (II-R. 66.) Thus the question exists: Did these contracts have the conditions attached to them as Klafter assumed? As the Tax Court found (I-R. 103), none of these conditions--free pool service, garbage collection, and rental service--attached to these contracts.

Taxpayers contend (Br. 27) that because American Homes Association was their selling agent, then the contracts it made pertaining to the pool, rental, and garbage services were binding on them under principles of agency law. The flaw in taxpayer's anaylsis is that they fail to

appreciate that American Homes was a corporation and, during the taxable years, was engaged in a dual capacity: It acted as an agent and as a principal. Thus there is no dispute that American Homes was solely an agent insofar as the selling of the duplexes was concerned. (I-R. 95.) As the Contract for Sale of Real Estate (Ex. 6-NNN) makes clear, it was the taxpayers who were the sellers, not American Homes. True, if the corporation did make representations regarding the duplexes, such representations may have bound taxpayers because the corporation was their agent. But it does not follow that the contracts entered into by American Homes on its own behalf and pertaining to its own properties or services could in any way bind the taxpayers.

The pool was owned by American Homes and operated by it. (I-R. 94.) It appears that it also arranged for the garbage service. 9/ Obviously, if it then entered into an agreement pertaining to these items, it was acting solely on its own behalf, i.e., as a principal. The contracts regarding these services were entered into by American Homes and a purchaser or tenant. None of the service contracts make reference to the deferred payment contracts, and vice versa. If there was a breach of a condition--for example, if American Homes attempted to charge for the pool prior to the time it had agreed upon--the contracting party could look to the corporation for damages, and to the corporation alone. Thus it is quite evident that these obligations to provide service were separate and distinct from the realty contracts.

9/ The garbage pick-up was to be handled by the Arizona Transport Agency. (Ex. 73-UUU(1).) The record does not indicate whether this was a private corporation or a municipal agency. In any event, it is clear that the taxpayers individually were not obligated to operate

As the Tax Court stated (I-R. 103), " * * * these were obligations of American Homes, a separate corporation, and not petitioners' obligations * * *". Clearly, then, Klafter was mistaken when he thought that these conditions were attached to the contracts and, therefore, any conclusion that the contracts had no fair market value--because of the conditions--would be in error.

As to the amount of the discount, Klafter testified (II-R. 67) that it would range from 40 percent to 65 or 70 percent, depending on such factors as the amount of the purchaser's equity, the earnings power of the purchaser, whether he had paid a fair price, and the purchaser's over-all financial responsibility. As to these factors, the Tax Court noted (I-R. 103):

> The record shows that such factors would be favorable, since the duplexes had all been completely reconditioned, the sales prices were not much in excess of a sales price suggested by an appraiser in 1953, the purchasers generally made cash down payments of at least 10 percent of the purchase price and in many cases even higher down payments, a purchaser could rent one-half of his duplex to a tenant, and finally, there is no indication that the payments on these contracts (which had to be paid in full within a five-year period) were not generally made as required.

We need but note that the Commissioner's 50 percent discount is within the range at which Klafter would have discounted these contracts.

It is axiomatic that the Commissioner's determination of fair market value is prima facie correct, and the burden is on the taxpayer to prove that it was erroneous. Fleming v. Commissioner, 153 F. 2d 361, 363 (C.A. 5th), and cases cited therein. As the record amply demonstrates, these taxpayers did not carry their burden.

CONCLUSION

For the reasons stated above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:____________________day of__________________, 1967.

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Attorney